National Center for Policy Analysis

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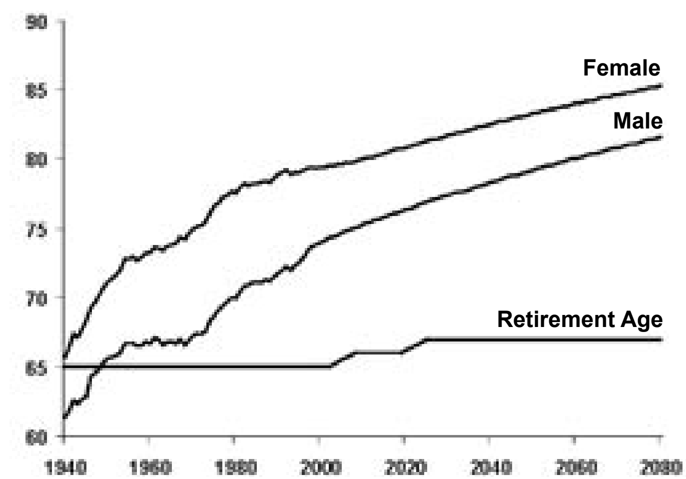
Social Security Reform: Looking at the Options

by Matt Moore

The present value of Social Security's long-term funding gap is $11 trillion in 2004 dollars. That means we would need $11 trillion in the bank today, earning the government's borrowing rate, to eliminate all of the program's future debt. Another way to reduce this debt is to reduce Social Security's obligations.

Life Expectancy vs. the Social Security Retirement Age



Sources: 2004 Annual Reports of the Board of Trustees of Social Security and Medicare.

In his 2005 State of the Union address, President Bush outlined four approaches to reduce traditional, government-funded Social Security benefits. Combined with proposed personal retirement accounts, these measures could close the program's long-term debt while providing benefits that approximate what the current system promises:

- Increase the retirement age over time to match the rise in life expectancy.
- Discourage early retirement or increase the rewards for later retirement.
- Means-test benefits.
- Change the indexing of benefits from wages to prices.

Each of these reforms would cut benefits, and since each has been endorsed at various points by both Republicans and Democrats, they could form the foundation for a possible bipartisan agreement.

Some see these as alternatives to personal retirement accounts. However, if one or more of these measures were combined with privately-owned retirement accounts, they could reduce Social Security's long-term debt while giving people the opportunity to earn back the money they lost.

Increasing the Normal Retirement Age. The normal retirement age is already rising for workers born after 1938. The retirement age began rising in 2003 by two months every year until it settles at age 67 for workers born in 1960 and later. Obviously, a higher retirement age means that retirees will collect benefits for fewer years, reducing Social Security's costs over time. The National Bureau of Economic Research estimates that this provision will reduce benefits by 24 percent for the average male retiree. The drive to raise the retirement age is understandable:

- When the Social Security program was implemented in the 1940s, life expectancy at birth was only 61.4 years for men and 65.7 for women; since the normal retirement age was 65 years, most workers died before qualifying for benefits. [See the figure.]
- Today, thanks in part to healthier lifestyles and the advancements of modern medicine, men are expected to live to age 74; women to age 79.
- By mid-century, men are projected to live to 79; women to age 83.

In response to the continued rise in life expectancies, some have called for accelerating the increase in the normal retirement age to 67 years; others have called for gradually raising the age to 70. Neither measure would eliminate Social Security's debt, but could help somewhat. According to the Social Security Advisory Board — an independent board appointed to advise the Social Security Administration — accelerating the increase would close just 8 percent of the program's long-term debt. Raising

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the age to 70 would reduce the debt by about a third. But at what cost? Requiring aging people to work additional years in physically demanding jobs like factory work and construction is unfair**.**

Discouraging Early Retirement. While the normal retirement age is currently 65 years 2 months and rising, workers can still opt for "early retirement" at age 62. Today, almost 70 percent of workers retire early! Of course, early retirement leads to permanently reduced benefits; for example, a worker who retires at age 62 would receive monthly benefits 20 percent lower than if the worker had reached normal retirement age. By contrast, workers who wait to apply for benefits until after the normal retirement age receive a permanent bonus. Even so, encouraging people to work longer will reduce the number of years they collect benefits and reduce total benefits paid over time.

There are several ways to discourage early retirement. Both the early retirement and normal retirement ages could be increased, the formula for reducing early retirement benefits could be changed to lower them even further, the incentives for later retirement could be increased, or some combination of the three.

Means Testing Benefits. "Means-testing" — or reducing retirement benefits paid to workers with higher incomes or retirees with extra assets — is one of the most popular suggestions to reduce future benefit payments. The most common means-testing plan was developed by the Concord Coalition. It would reduce Social Security benefits by 10 percent for retirees with family incomes of $40,000 a year and an additional 10 percent for every additional $10,000 of income, up to a maximum reduction of 85 percent. The 1994-1996 Advisory Council on Social Security and a 2001 report by the Social Security Advisory Board suggest this plan could close three-fourths to 89 percent of Social Security's long-term debt over the next 75 years. But means-testing specifically targets people who were responsible and saved more during their working years, a behavior we want to encourage.

Social Security currently redistributes benefits from rich to poor. While people who pay more taxes get a higher pension in retirement, the benefit structure is skewed so lower-income people get a higher return on their taxes than do wealthier people. Even so, Social Security is social insurance, not a welfare program. As such, it is based on the notion that everyone who pays in gets something back. Means-testing violates this compact by forcing some citizens to pay the costs but receive none of the benefits, jeopardizing the program's universal support.

Changing the Indexing of Benefits from Wages to Prices. Many of the leading reform plans before Congress — including Model 2 of the 2001 Commission to Strengthen Social Security, and a plan by Sen. Lindsay Graham (R-S.C.) — would change the indexing of initial benefit payments from wages to prices. Because wages rise faster than prices, this would slow the growth of future benefits and eliminate Social Security's long-term debt. This provision will not affect the benefits of current retirees, and all workers — even those with reduced initial benefits — would continue to receive cost of living increases as prescribed under current law.

Because initial Social Security benefits are wage indexed under current law, the purchasing power of benefits is scheduled to rise. A person retiring in 2040, for example, can expect a benefit 40 percent higher than today's retirees receive, in real terms. Tying future benefit increases to prices would give future retirees the same purchasing power as today's retirees, but would replace a smaller portion of a future worker's preretirement income.

Those most affected would have more time to make other arrangements for their retirements. A 47-year-old today would receive 90 percent of currently scheduled benefits upon retirement. Benefit levels decline to 85 percent for 37-year-olds and to 74 percent for today's 27-year-olds. This proposal could also be made progressive by subjecting higher-wage workers to price indexing while lower wage workers continue under wage indexing.

The Role of Personal Retirement Accounts. Regardless of which method Congress eventually adopts, today's younger workers and future generations face additional burdens. Adding a personal retirement account to any of the options outlined above will give younger workers a way to make up their losses.

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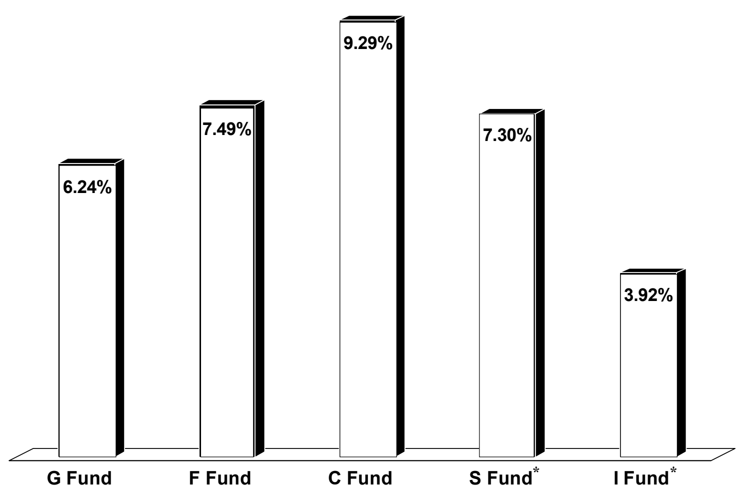
The Federal Thrift Savings Plan: A Model for Social Security Reform

by Matt Moore

In just 15 years, workers' Social Security payroll taxes will fall short of what is needed to pay promised benefits, and the system will require increasing cash transfers from general revenues. One way to begin alleviating the shortfall is to allow workers to set aside a portion of their Social Security taxes in Personal Retirement Accounts (PRAs). These accounts would earn a market return over the workers' lives and replace some of the retirement benefits promised by Social Security. However, there are several concerns about a PRA system:

- Would the government be able to manipulate the stock market or make politically motivated investment decisions with PRA funds?
- Would inexperienced investors make poor investment choices?
- Would investors be subject to undue risk due to stock market volatility?

Thrift Savings Plan: 10-Year Average Annual Returns
(1993 through 2002)



* The returns shown reflect the actual performance of the S and I Funds for May 2001 and subsequent months. For the first four months of 2001 and for prior years, the S and I Fund returns shown reflect the performance of the Wilshire 4500 and EAFE indexes (without deduction of any administrative expenses, trading costs, or investment management fees).

Source: Thrift Savings Plan, "Rates of Return, History Summary," January 21, 2003, online at http://www.tsp.gov/rates/history.html.

Used as a model, the Thrift Savings Plan (TSP) — a low-risk, low-cost retirement savings plan for federal employees — demonstrates ways to allay these concerns. The TSP is a voluntary program that functions like a 401(k) for federal employees, including members of Congress. Currently, the TSP manages about $100 billion in three million federal employees' individual accounts. The TSP:

1. Insulates Investments from Politics. The TSP has three features designed to insulate the fund from politics — including attempts to use the participants' savings to make political or ethical statements, influence corporate behavior or fund federal government deficits.

First, an independent Federal Retirement Thrift Investment Board administers the TSP. The board is comprised of five part-time presidential appointees who serve four-year terms and select a full-time executive director. The board is regularly audited and reviewed.

Second, the law requires the board to act in the best interest of the plan's participants and beneficiaries. Failure to do so would subject the board's members and employees to civil and criminal liability. According to TSP Executive Director Roger W. Mehle, "Congress wisely established this fiduciary structure because it recognized that all funds held in trust by the plan belong to the participants, not the government, and thus must be managed for them independent of political or social considerations."

Third, the structure of the TSP discourages political manipulation. The TSP invests in index funds rather than individual stocks. "Indexing" is a form of passive management in which securities are held in proportion to their share of the stock or bond markets as a whole. For example, the TSP's government securities investment fund holds special issue U.S. Treasury bonds.

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And the stock index fund tracks common stock indexes such as the Standard & Poor's 500 or Wilshire's 5000.

2. Protects Inexperienced Investors. TSP participants are not able to pick individual stocks. Rather, they choose their investment allocation from among five pre-constructed plans: U.S. Treasury bonds, common stocks, fixed income assets, international stocks and small capitalization stocks. These funds carry varying degrees of risk and reward.

Government Securities Investments. The "G" Fund is invested in short-term U.S. Treasury bonds guaranteed by the federal government. There is no possibility of a loss of principal, thus no risk of loss.

Fixed Income Index Investments. The "F" Fund is invested in a bond index fund, currently the Lehman Brothers Aggregate (LBA) index, which represents a diversified group of U.S. government, corporate and mortgage-related securities. Through the G and F Funds, TSP participants with low risk tolerance can avoid the stock market entirely.

Common Stock Index Investments. The "C" fund is invested in a portfolio that tracks the stock market as a whole by replicating the performance of an index such as the Standard & Poor's 500.

Small Capitalization Stock Index Investments. The "S" Fund is invested in a portfolio that replicates the performance of an index that includes common stocks, excluding the stocks in the C Fund. It currently uses the Wilshire 4500 index, which tracks the performance of the non-S&P 500 stocks in the U.S. market. Thus, the S and C Funds together cover almost the entire U.S. stock market.

International Stock Index Investments. The "I" Fund is invested in a portfolio designed to track the performance of an index that represents the international equity markets. The board chose to mirror the Morgan Stanley EAFE (Europe, Australasia, Far East) index, which tracks the stock markets in 21 countries.

The board selects the assets manager of the F, C, S, and I funds through competitive bidding, so individual workers are not bombarded by advertisements and promotional materials. Potential asset managers are evaluated on objective criteria, including their ability to track the relevant index, low costs, fiduciary record, experience and fees, according to TSP Executive Director Mehle. Currently, the board contracts with BGI, the largest American index funds investment manager. BGI invests TSP participants' savings in trust funds in which the holdings of public and private employee benefit plans are invested together.

3. Avoids Unnecessary Risk. How do TSP accounts fare? The figure shows TSP returns after deducting administrative expenses, and trading costs and accrued investment management fees. It shows that the funds' 10-year returns have been positive, despite ups and downs during the period.

TSP participants — and prospective personal account holders — should take note. While the market goes up and down from year to year, it is important to think long-term. For example, take the S&P 500 index on which the C Fund is based. An analysis of the returns on investment in the Standard and Poor's 500 Index by economists at the Private Enterprise Research Center at Texas A&M University shows:

- Over any 35-year period ending between 1872 and 2000, the market provided an average annual return of 6.4 percent after inflation.
- There were positive gains in every 35-year period and each outperformed what Social Security will pay in return for workers' payroll taxes.

And, as previously outlined, accounts need not be invested in stocks. Workers could instead invest in government or corporate bonds, which tender less risk but yield smaller returns.

Conclusion. Of course, the Thrift Savings Plan and Personal Retirement Accounts differ in significant ways. Notably, the TSP monitors fewer than 5 million accounts, while the Employee Benefits Research Institute predicts that a Social Security PRA plan could include up to 148 million participants. This difference in scale would impose limitations. Many options available to TSP participants, such as the ability to borrow against their accounts, would likely be unavailable to personal account holders. Social Security PRAs would be more difficult to manage because participants' incomes, earnings records, and types of employers and employment would be so diverse. Still, the TSP is an excellent small-scale model for the structure and administration of PRAs.

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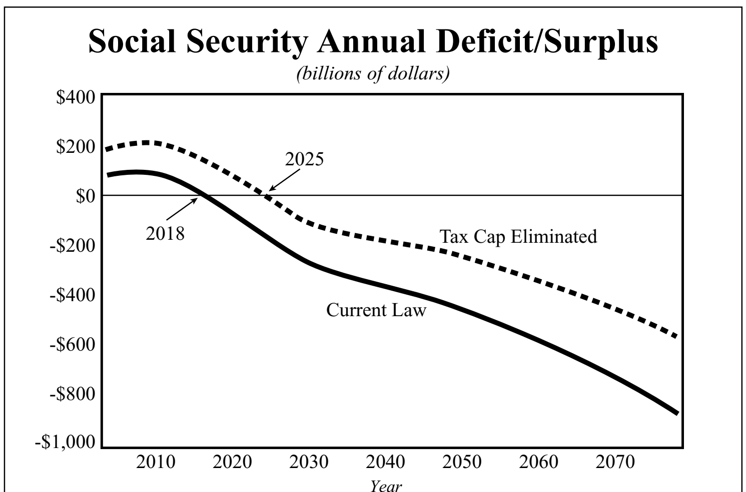
Eliminating the Social Security Payroll Tax Cap: A Bad Idea

by Matt Moore

Most proposals to address Social Security's looming insolvency would integrate a private investment component into the current system, allowing younger workers to fund part of their own future benefits by investing a portion of their Social Security taxes today.

Opponents of personal retirement accounts suggest other ways to address Social Security's long-term insolvency. One of the most common alternatives would raise or eliminate the Social Security payroll tax cap on wages. While removing the cap would somewhat reduce the program's long-term debt, it would create significant unintended consequences for taxpayers and the economy.



Source: Social Security Administration.

Social Security's Pay-As-You-Go Funding. Social Security pays benefits to today's retirees with tax payments from today's workers. When current workers retire, their benefits will be paid by future workers. This system works as long as there are enough people working to pay the bills. But when the 77 million baby boomers retire, the amount the rest of us contribute won't cover all the new retirement checks. In 2018 Social Security will begin paying more than it will collect in taxes, and the deficits begin to grow larger over time.

What is the Social Security Tax Cap? The Social Security payroll tax is 12.4 percent of wages — half from the employee, half from the employer. The wage cap establishes the maximum earnings to which the Social Security payroll tax applies. The level is currently set at $87,900, and it automatically rises with inflation each year. Because of the cap, the maximum Social Security payroll tax is about $10,900 per year. (Note: An additional payroll tax of 2.9 percent is collected on all wages for Medicare.)

Two Ways to Eliminate the Payroll Tax Cap. The payroll tax cap could be eliminated in one of two ways:

- The payroll tax cap could be eliminated and workers would earn benefits from the new payments;
- Or the cap could be eliminated and workers *would not* accumulate new benefits.

Both options would increase Social Security tax collections. The first option would also increase Social Security's cost in later years as higher-wage workers retire and collect larger benefits. The second option would break the link between contributions and benefits, making Social Security more like a welfare program than a social insurance program.

Effects of Eliminating the Payroll Tax Cap. A new Social Security Administration report estimates the effect of removing the payroll tax cap. It assumes wages subject to the tax will decline as many workers shift their incomes from covered wages to income sources not covered by the tax like stock options or other benefits. According to author calculations based on the report's findings, removing the cap would:

- Push back the date of Social Security's cash-flow deficit from 2018 until 2025 — giving Social Security only seven additional years of surpluses. [See the figure.]
- Increase the Treasury bonds deposited in the Trust Fund by $3 trillion, up to $7 trillion at its peak.
- Increase Social Security's income by $14 trillion over the next 75 years, reducing Social Security's 75-year

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debt from $27 trillion to near $14 trillion, but still leaving a significant debt.

Eliminating the payroll tax cap immediately affects the 9.2 million Americans who earn more than $87,900, raising their marginal tax rate — the tax paid on each additional dollar of wage income — by 12.4 percent. As a result, earners in the top income tax bracket (35 percent) would pay more than half of each additional dollar they earn in taxes. For example:

- A family earning $100,000 would pay $1,500 more per year ($100,000 less $87,900 times the 12.4 percent payroll tax).
- A family earning a million dollars a year would face new Social Security taxes of $113,100.

Problem: Economic Costs of Raising the Tax Cap. Increasing the marginal tax rate will have adverse economic consequences. The Social Security payroll tax already has an economic cost. According to a recent NCPA study by economists Liqun Liu and Dr. Andrew J. Rettenmaier of the Private Enterprise Research Center at Texas A&M University, the current system encourages people to work fewer hours and produce fewer goods and services, relative to an efficient tax system:

- The cost to society as a whole from the Social Security payroll tax alone is 11 cents to 18 cents for every dollar of tax revenue collected.
- This loss amounted to $49 billion to $82 billion in 2001, or as much as $804 for every household in America.

Increasing the payroll tax will exacerbate these already existing losses. According to the Heritage Foundation's Center for Data Analysis:

- Eliminating the cap would constitute the largest tax increase in American history — some $461 billion over the first five years alone.
- Over the first 10 years, it would cost the economy nearly $136 billion in lost growth and cause the loss of more than 1.1 million new jobs.

Problem: The Social Security Trust Fund Can't Save the New Money. For the next 14 years, Social Security is projected to run a small, declining annual surplus, which is supposedly saved in the Trust Fund. By 2018, under current law, the Social Security Trust Fund will be credited with some $5 trillion.

But there is no cash in the Trust Fund. Every dollar collected by the Trust Fund is immediately "borrowed" by the U.S. Treasury and used to fund other programs or pay down debt. Meanwhile, the Trust Fund's cash is replaced with special U.S. Treasury bonds. Benefits cannot be paid unless the bonds are cashed in, and the only way to cash in the bonds is for the U.S. Treasury to increase income taxes, cut spending on other programs or borrow. Thus, every dollar put in the Trust Fund will have to be raised *again* in the year the fund's bonds are needed to pay benefits. That requires a significant commitment of resources from future taxpayers. For this reason, the date on which Social Security begins paying more in benefits than it collects in taxes (currently 2018) is more important than the Social Security Trust Fund exhaustion date (currently 2042).

As noted above, elimination of the payroll tax cap pushes back Social Security's first negative cash flow year for only seven years, and increases the Social Security trust fund's bonds by some $3 trillion. But like the holdings of the current trust fund, every dollar is spent and must be raised again when the bills are due.

Personal Retirement Accounts Improve the Tax Cap Increase. As noted earlier, one of the problems with raising the Social Security tax cap is that there is no way to save the newly-generated revenues. Any cash collected will be spent on other government priorities and replaced with IOUs, as occurs under current law. If the payroll tax cap must be eliminated, personal retirement accounts could capture the new revenues and ensure the new funds are saved for retirement spending.

Conclusion. While eliminating the Social Security payroll tax cap would reduce the funding gap somewhat, it has only a marginal effect and comes with a huge economic cost.

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